DEPARTMENT OF STATE REVENUE

04-20110235.LOF

Letter of Findings: 04-20110235
Gross Retail Tax
For the Tax Years 2007-2009

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ISSUES

I. Sales and Use Tax–"Maintenance Agreements"

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-17; IC § 6-8.1-3-3; IC § 6-8.1-5-1; 45 IAC 2.2-4-2; Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44 (Ind. Tax Ct. 2000); Information Bulletin 2 (December 2006); Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (November 2000); Letter of Findings 04-20050438 (August 11, 2006).

Taxpayer protests the imposition of use tax on its purchase of "maintenance agreements."

II. Sales and Use Tax–"Kitting Activities"

Authority: IC § 6-2.5-2-1; IC § 6-2.5-5-3; IC § 6-8.1-5-1; 45 IAC 2.2-4-2; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); North Cent. Industries, Inc., Co. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992); Indiana Dep't of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Letter of Findings 04-20000017 (May 13, 2004).

Taxpayer protests the imposition of sales and use tax on its purchases used during its "kitting activities."

STATEMENT OF FACTS

Taxpayer operates two facilities in Indiana. Taxpayer sells cell phone accessories and performs logistic and fulfillment services. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional use tax for the tax years 2007, 2008, and 2009. The Department found that Taxpayer had made a variety of purchases on which sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer disagreed with some of the audit results and protested. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax–"Maintenance Agreements"

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer purchased various software "maintenance agreements." During the audit, the Department found instances where Taxpayer had purchased software "maintenance agreements" without paying sales tax at the time of purchase, and assessed used tax on the purchases.

Taxpayer maintains that since the software "maintenance agreements" do not contain a provision which guaranteed that Taxpayer would automatically receive software updates and upgrades, the software "maintenance agreements" are not subject to Indiana sales/use tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

In support of its position that the transactions are not subject to sales/use tax, Taxpayer points to 45 IAC 2.2-4-2(a) which states:

> Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax....

Taxpayer also points to Sales Tax Information Bulletin 2 (May 2002) as "outlin[ing] the position of the Legislature and the Department regarding optional maintenance agreements." An earlier version of Information Bulletin 2 stated as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002) (Emphasis Added) (See also Sales Tax Information Bulletin 2 (November 2000) "Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.")

Taxpayer acknowledges that the Department subsequently amended the information bulletin revising its position. That revision states:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. Information Bulletin 2 (December 2006) (Emphasis Added).

Taxpayer relies on the May 2002 Information Bulletin, 25 Ind. Reg. 3595, as supporting its position that its maintenance agreements are exempt from sales tax because the maintenance agreements it purchased purportedly do not contain the right to obtain updates. Taxpayer challenges the position taken in the revised December 2006 Information Bulletin because the Department did not promulgate an accompanying regulation. Taxpayer cites to IC § 6-8.1-3-3 which requires as follows:

> (a) The department shall adopt, under IC 4-22-2, rules governing:
> (1) the administration, collection, and enforcement of the listed taxes;
> (2) **the interpretation of the statutes governing the listed taxes**;
> (3) the procedures relating to the listed taxes; and
> (4) the methods of valuing the items subject to the listed taxes.
> (b) **No change in the department's interpretation of a listed tax may take effect before the date the change is:**
> (1) adopted in a rule under this section; or
> (2) **published in the Indiana Register** under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule; if the change would increase a taxpayer's liability for a listed tax.
> (**Emphasis Added**).

IC § 6-8.1-3-3 states that if the Department changes its "interpretation of a listed tax," it must either adopt a rule (regulation) under IC § 4-22-2 or give notice of that interpretation in the Indiana Register.

Taxpayer correctly points out that the Sales Tax Information Bulletin 2 (December 2006), 20100804 Ind. Reg. 045100497NRA, was not published in the Indiana Register until August 2010.

The previous 2002 version of the Information Bulletin did not require the vendor to collect sales tax on the sale of the extended warranties and maintenance agreements; however the vendor was required to self-assess use tax on any parts supplied pursuant to the terms of the warranty or agreement. The subsequent version of the Information Bulletin (2006) essentially reversed that requirement. The vendor was required to collect sales tax on the sale of the warranty but was not required to self-assess use tax on any parts supplied pursuant to the terms of the warranty. Presumably the subsequent version of Information Bulletin (2006) was a "change in the department's interpretation of a listed tax" as described in IC § 6-8.1-3-3 and triggered the Department's obligation to either adopt a regulation or publish notice of that "change" in the Indiana Register.

However, the Department must point out that prior to the issuance of the Information Bulletin 2 (December 2006), the Department issued Letter of Findings 04-20050438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, in which the Department addressed the question of whether "Software Maintenance Agreements" were subject to sales tax. The Department found that these agreements were subject to sales tax on a "prospective basis" as follows:

> There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin [] 2 concerning Optional Warranties... on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation only if there was a guarantee of the transfer of tangible personal property (updates) pursuant to the agreement.
>
> Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin [] 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. Wholesalers, Inc. v. Indiana Department of State Revenue, 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, **the department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax.** A taxpayer could rebut this presumption by demonstrating that no

updates were actually received pursuant to a particular maintenance agreement or optional warranty.

In this particular taxpayer's situation, the department will apply this interpretation prospectively. (Published in the Indiana Register and available at http://www.in.gov/legislative/iac/20061101-IR-045060474NRA.xml.html) (**Emphasis added**).

As of the publication of Letter of Findings 04-20050438 (August 11, 2006), the Department fulfilled its obligation to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the Letter of Findings, "The taxpayer's protest is sustained as to the maintenance agreements and optional warranties in this assessment. The taxpayer is advised that in the future, there will be a rebuttable presumption that all software maintenance agreements and optional warranties will be subject to the sales and use taxes."

In the case of the software maintenance agreements, the interpretations set out in the Sales Tax Information Bulletins are irrelevant. Instead, the interpretation set out in the August 2006 Letter of Findings governs the issue. The publication of that Letter of Findings met the requirements set out in IC § 6-8.1-3-3. See Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44, 49 n.5 (Ind. Tax Ct.) ("The publication of the Letter of Findings is a prerequisite for the Department before it can change its position as to the interpretation of a tax, where the change would increase the taxpayer's liability.")

The Department is not required to discern whether the maintenance agreement vendors did or did not provide Taxpayer with computer software updates or whether the underlying agreement guaranteed that updates would be provided. The Department presumes that updates were provided pursuant to the agreements.

In addition, Taxpayer further maintains that software maintenance agreements were not subject to Indiana sales/use tax until the enactment of IC § 6-2.5-4-17 in July 1, 2010, which provides that " a person is a retail merchant making a retail transaction when the person enters into a computer software maintenance contract to provide future updates or upgrades to computer software."

However, the Department must disagree. As discussed previously, the Department has consistently found that software maintenance agreements were subject to sales and use tax for several years prior to the enactment of this legislation. Therefore, even when Taxpayer's argument–that this legislation changed the law–is presumed correct, a change from the current law would be changing the law from software maintenance agreements being subject to tax with a rebuttable presumption to software maintenance agreements always being subject to tax without the availability of a rebuttable presumption.

FINDING

Taxpayer's protest to the imposition of use tax on its purchases of software "maintenance agreements" is respectfully denied.

II. Sales and Use Tax–"Kitting Activities"

DISCUSSION

The Department again notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The Department determined that Taxpayer had made several purchases without either paying sales tax at the time of purchase or remitting use tax to the Department, and assessed use tax on the purchases.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Taxpayer makes the general assertion that certain of its purchases that are used in its "kitting" activities are not subject to use tax because the purchases would qualify for the manufacturing equipment exemption under IC § 6-2.5-5-3. Taxpayer further maintains in the situations where it does not purchase the cell phones and accessories it uses in the "kitting" activities, Taxpayer qualifies for the manufacturing exemption as an industrial processor as found in 45 IAC 2.2-5-10. In regards to the factual basis of Taxpayer's protest, Taxpayer's protest letter states:

> [Taxpayer's] operations relate to assembly of telecommunication components for delivery to customers; a process commonly referred to as "kitting." "Kitting involves the transformation of an unusable product (i.e. a non-functioning cell/smart phone) into a usable product (i.e., a fully-functioning cell/smart phone). "Kitting" includes, but is not limited to, programming and installation of a SIM card, installation of a battery, assembling the applicable instruction manual, phone charger, related software and any other accessories or materials into a final package for delivery to the customer. As such, Taxpayer routinely purchases various pieces of equipment and warehouse supplies that are utilized or consumed throughout the course of the production process.

Taxpayer also refers to AOL, LLC. v. Indiana Dep't of State Revenue, 49T10-0903-TA-7 (Ind. Tax Ct. Dec 29, 2010) as supporting its position. While the Department does not agree that AOL, a case about the use tax consequences on AOL's purchase of "formatted CDs" and "promotional materials," is relevant to Taxpayer's situation of its purchases of equipment it used as a retailer and provider of logistic and fulfillment services, the Department declines the invitation to discuss the case in more detail. Not only is the AOL case an unpublished

decision that cannot be cited for precedent as found at Ind. R. App. P. 65(D), it is also not a final decision as the Indiana Supreme Court has granted the Department's petition for review and has yet to issue its decision on the matter.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Additionally "[e]xemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." Id.

Notwithstanding that Taxpayer failed to present sufficient documentation explaining the items at issue and how specifically Taxpayer uses those items, Taxpayer's purchases would not qualify for the manufacturing exemptions found at IC § 6-2.5-5-3. Taxpayer is a not a manufacturer of goods for sale. The Department notes that it has addressed this issue of Taxpayer's "kitting" activities for Taxpayer's parent corporation and issued Letter of Findings 04-20000017 (May 13, 2004), 27 Ind. Reg. 3779 (August 1, 2004), in which the Department denied the Taxpayer's protest finding that Taxpayer's "kitting" activities did not qualify as manufacturing.

As to the substance of Taxpayer's protest, the Department's regulations emphasize that the tangible personal property that are the "raw materials" of a manufacturing/processing/refining process must be substantially changed in their "form, composition, or character" such that the resulting tangible personal property is a different product having a distinctive "name, character, and use." The resulting product must be substantially different from the component materials used.

45 IAC 2.2-5-8(k) states:

> "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in **a form, composition, or character different from that in which it was acquired.** The change in form, composition, or character must be **a substantial change,** and it must result in a transformation of property **into a different product** having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition. (**Emphasis added**).

45 IAC 2.2-5-10(k) states:

> Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change. Operations such as distilling, brewing, pasteurizing, electroplating, galvanizing, anodizing, impregnating, cooking, heat treating, and slaughtering of animals for meal or meal products are illustrative of the types of operations which constitute processing or refining, although any operation which has such a result may be processing or refining. **A processed or refined end product, however, must be substantially different from the component materials used.**
>
> (**Emphasis added**).

Based upon the documentation submitted, Taxpayer does not perform operations on the property that cause a "substantial change" in "form, composition, or character" to the component materials it used. Taxpayer is a retailer and/or service provider. Taxpayer obtains large quantities of packaged goods–i.e., cell phone, cell phone accessories, and instruction manuals–that are produced by someone else, repackages the goods for sales to consumers, and ships them to other retailers/businesses or directly to the consumer. The cell phones, cell phone accessories, and instruction manuals that have been packaged by Taxpayer have not undergone a "substantial change" in "form, composition, or character" and are not substantially different than the cell phones, cell phone accessories, and instruction manuals that Taxpayer obtains from the manufactures. Thus, Taxpayer's "kitting" activities constitute the performance of a service where Taxpayer repackages goods that are manufactured by others.

The Tax Court addressed the issue of repacking in North Cent. Industries, Inc., Co. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003), where the taxpayer bought fireworks in bulk and sold packages containing a variety of fireworks. In that case, the court explained:

> North Central does not create a new, marketable product; it merely packages existing fireworks into boxes, then labels and shrink-wraps them. This is not the sort of substantial change or transformation that places the fireworks "in a form, composition, or character different from that in which [they were] acquired." 45 IAC 2.2-5-8(k). See also Indianapolis Fruit, 691 N.E.2d at 1386; Mechanics Laundry & Supplies, Inc. v. Indiana Dep't of State Revenue, 650 N.E.2d 1223, 1229 (Ind. Tax Ct. 1995) (holding that producing a good is not merely perpetuating already existing goods); Harlan Sprague Dawley, 605 N.E.2d at 1229; Faris Mailing, 512 N.E.2d at 483. Nor does North Central's process increase the number of "scarce economic goods," see Harlan Sprague Dawley, 605 N.E.2d at 1225, because the same number of fireworks are sold regardless of the way they are packaged. Consequently, North Central's activities do not constitute the direct production or

manufacture of other tangible personal property.

Id. at 201-2.

Since Taxpayer is not the manufacturer of the goods and merely provides a service repackaging goods produced by another, Taxpayer is not entitled to the manufacturing exemptions. Therefore, Taxpayer's protest to the imposition of use tax on its purchases involved in its "kitting" activities is denied.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer's protest, as discussed in Issue I and II, is respectfully denied.

Posted: 03/28/2012 by Legislative Services Agency

An html version of this document.